The Missouri PSC established permanent rates in its First Arbitration Order and interim rates in its Second Arbitration Order in full compliance with this Commission's TELRIC rules. The district court recognized that "[t]he PSC did apply TELRIC methodology when making its pricing decisions." AT&T Communications, 86 F. Supp. 2d at 949 n.7 (emphasis added). AT&T argued not only that the PSC applied TELRIC but that its application of TELRIC was fully justified. Id. at 949. On appeal, the Eighth Circuit reversed and remanded the case back to the Missouri PSC precisely because TELRIC had been applied and because the court had concluded six months earlier that TELRIC was inconsistent with the 1996 Act. See Southwestern Bell Tel. Co. v. Missouri Pub. Serv. Comm'n, 236 F.3d 922, 924 (8th Cir. 2001) ("The PSC's pricing decision that is challenged here was made by reference to the FCC's chosen method of cost-based pricing. . . . We therefore conclude that the holding in [Iowa Utilities Board, 219 F.3d 744] invalidating the TELRIC pricing methodology requires that the entire arbitrated agreement approved by the PSC in this case be vacated and that further proceedings . . . be held.") (emphasis added), petition for cert. pending, AT&T Communications of the Southwest, Inc. v. Southwestern Bell Tel. Co., No. 00-1689 (filed May 8, 2001).

No party has challenged either the First Arbitration Order or the Second Arbitration Order (or, indeed, any subsequent order adopting rates first established in those orders) on the grounds that the Missouri PSC failed to apply TELRIC or improperly considered SWBT's historical costs in setting rates. And it is worth noting, of course, that the actual rates contained in the M2A that were derived from either arbitration order are equal to or lower than the rates that have universally been recognized as complying with this Commission's TELRIC methodology. For these reasons, it is entirely appropriate for the M2A to incorporate rates derived from the two arbitration orders; such rates, which are equal to or lower than the rates

found to be TELRIC-based by two federal courts, are clearly cost-based within the meaning of sections 252(d)(1) and 271(c)(2)(B)(ii).

3. Availability of Electronic Cost Studies

In the initial Missouri 271 proceedings, some commenters argued that SWBT somehow improperly prevented CLECs from gaining access to its cost models and inputs. But Southwestern Bell has provided precisely the same cost information as part of its Application for section 271 relief in Missouri as it provided in Texas, Kansas, and Oklahoma. See B. Smith MO Aff. ¶ 41. Southwestern Bell has never previously provided cost studies in electronic form as part of its section 271 application, nor has anyone ever asked it to do so. Electronic versions of the 1997 LPVST cost study, the 1997 ACES model, and the 1997 CAPCOST study are simply no longer available in electronic form. In an effort to accommodate the request for electronic versions of the cost studies, SBC has provided a CD-ROM containing currently available and analogous studies – the UNE Loop Cost Study; the CAPCS model, populated with the Missouri capital cost inputs; and the ACES spreadsheets, modified into Excel format. See id. ¶ 41 n.5 & Attach. E.

Furthermore, no CLEC ever complained about access to electronic versions of SWBT's cost studies before the Missouri PSC. And this is not surprising, given that both WorldCom and AT&T had been active participants in the cost portion of the Texas Mega-Arbitration, where the exact same cost models were being used. See id. ¶ 42. As part of the Texas Mega-Arbitration, the Texas Commission required SWBT to provide CLECs with training and access to SWBT's cost models. During the week of January 27, 1997, SWBT held a five-day training course in Austin, Texas to train CLEC personnel on the SWBT models and SWBT cost studies. CLECs had access to electronic and paper versions of every SWBT cost study. During this week-long

training course, 19 people from AT&T and WorldCom attended. After the workshop in Texas, mini-workshops were held in February and March 1997. See id. As part of the Texas Mega-Arbitration, CLECs deposed almost 100 subject matter experts who had provided inputs to the SWBT cost studies. It is simply untrue, therefore, that AT&T and WorldCom did not have access to these cost studies.

In Missouri, SWBT made its cost studies and voluminous supporting documentation available in September and October 1996 to representatives of both AT&T and WorldCom. See Kern MO Aff. ¶¶ 4-7 (App. A – MO, Tab 13). The traditional nondisclosure agreement was revised to allow employees of AT&T and WorldCom access to the cost studies, and those studies were sent to Austin, Texas to allow AT&T and WorldCom greater access. See B. Smith MO Aff. ¶ 42. Several representatives from both companies reviewed the cost materials in Austin. See Kern MO Aff. ¶ 5. In October 1996, throughout the hearings in Case No. TO-97-40, the cost studies and material were made available to both AT&T and WorldCom in Jefferson City, Missouri. Id. ¶ 6. A number of AT&T and WorldCom representatives in fact reviewed the studies and supporting material during this period. Id. ¶ 7.

The complaints about access to SWBT's cost studies are a smokescreen. All of the cost models supporting the UNE rates have been submitted with this Joint Application in paper form. See App. G – MO, Tab 6; App H – MO, Tab 46. That is no different from the way this cost evidence has always been submitted to this Commission in section 271 applications. Moreover, the electronic versions of these studies were all made available as part of the Texas Mega-Arbitration. Because SWBT's cost studies during this period were the same throughout its region, CLECs had access to them in any number of different cost proceedings.

4. UNE Rates in General

In arbitrating the rates as part of Case No. TO-97-40, the Missouri PSC thoroughly and carefully reviewed thousands of inputs that the parties proposed. It had to make difficult and controversial choices among proposals that often varied substantially from one another. Nevertheless, the Missouri PSC applied a forward-looking methodology and set rates that were consistent with this Commission's TELRIC principles. The Missouri PSC did so notwithstanding the fact that the Commission's TELRIC methodology had been invalidated and was inapplicable at the time of the First Arbitration Order. Indeed, in reviewing the rates that were established in this docket, the United States District Court for the Western District of Missouri rejected this Commission's request that it remand the pricing issues to the Missouri PSC "to reconsider its pricing decisions in light of the TELRIC regulations," because, in the view of the district court, the PSC had already done so – "a remand on this ground would serve no purpose." AT&T Communications, 86 F. Supp. 2d at 949 n.7

In the initial Missouri proceedings, some commenters asserted that SWBT's UNE rates are improperly inflated by certain assumptions relating to depreciation rates, allocation of common costs, and power and engineering costs that all violate TELRIC principles. This is demonstrably false.

Depreciation. In the Local Competition Order, this Commission explained that "an appropriate calculation of TELRIC will include a depreciation rate that reflects the true changes in economic value of an asset and a cost of capital that appropriately reflects the risks incurred by an investor." 11 FCC Rcd at 15856, ¶ 703. In a footnote, the Commission elaborated further that, "[p]roperly calculated," economic depreciation "is a periodic reduction in the book value of an asset that makes the book value equal to its economic or market value." Id. n.1711.

In establishing the UNE rates, the Missouri PSC clearly adopted a depreciation rate reflecting the true changes in economic value of SWBT's assets. In an exhaustive analysis of depreciation, the Missouri PSC Staff reasoned that, at least with respect to the kind of equipment used in the provision of local telephone service, "[e]conomic obsolescence has overtaken physical deterioration as the primary cause of loss of value and retirements." Costing and Pricing Report at 99. In other words, "[i]t is the competitive market demand for the newest features and functions that controls the economic life of telephone equipment, rather than the physical durability of that equipment, as was the case under rate of return regulation." Naughton MO Aff. ¶ 7 (App. A – MO, Tab 18).

The regulatory "prescribed rates" are not appropriate because they are based on physical obsolescence, rather than on economic obsolescence. See id. ¶ 5. Moreover, the prescribed rates are not forward looking and rely on equipment life ranges that were developed in the mid-1990s, based on even older data. See id. As the Missouri PSC Staff explained, "a reasonable assumption is that TELRIC telephone plant will probably not be able to be depreciated over as long a life as embedded plant." Costing and Pricing Report at 101; id. at 105 ("one must take the perspective of an investor creating a network from scratch today"). So it is entirely reasonable to assume that, in a competitive environment, a "company's depreciation life must be short enough to recover its investment from the pool of customers receiving benefit from that plant, or risk never recovering the investment fully." Id. at 100.[29]

[29] There is nothing inconsistent in the way the maintenance expenses have been calculated and the use of shorter depreciation lives for plant. SWBT's maintenance expenses are calculated based on a factor applied to forward-looking investment, not to booked investment. Therefore, the maintenance expenses in SWBT's cost studies are lower than the booked maintenance expenses, as one would expect for plant using shorter depreciation lives. See Costing and Pricing Report at 83-84.

The depreciation lives established by the Missouri PSC were based on SWBT's proposals as modified by the Missouri PSC Staff. As Barbara Smith explains, the depreciation lives are very close to the lives that AT&T itself uses in its own depreciation calculations for the same categories of plant. See B. Smith MO Aff. ¶ 98. The Missouri PSC Staff compared AT&T's and SWBT's depreciation rates and found that, with respect to the most significant investments, "[t]he numbers compare favorably." Costing and Pricing Report at 105. Just as this Commission rejected AT&T's challenge to the Oklahoma depreciation rates in the Kansas/Oklahoma Order (¶ 76), so should it do so here. As in the prior proceeding, this Commission should refuse to require state commissions to adopt this Commission's depreciation rates and reaffirm that "[a] state may find that a depreciation schedule such as the one proposed by SWBT is appropriate." Id.

Common Costs. In the Local Competition Order, this Commission recognized that, because common costs are incurred in the provision of network elements, "setting the price of each discrete network element based solely on the forward-looking incremental costs directly attributable to the production of individual elements will not recover the total forward-looking costs of operating the wholesale network." 11 FCC Rcd at 15852, ¶ 694. Moreover, this Commission explained that "[o]ne reasonable allocation method would be to allocate common costs using a fixed allocator, such as a percentage markup over the directly attributable forward-looking costs." Id. at 15853, ¶ 696.

SWBT developed its common cost allocator by dividing its total common costs by its total expenses, defined to include operating expenses, capital-related costs of return on capital, depreciation and income tax expenses, and excluding any common costs. See B. Smith MO Aff.

¶ 102. The resulting factor is applied to the forward-looking TELRIC cost of the UNE to provide the basis for the forward-looking UNE price. Id.

After reviewing SWBT's common cost allocator study, the Missouri PSC Staff had "no specific concerns or proposed modifications." Costing and Pricing Report at 125. Calculating the allocator using total revenues rather than total expenses in the denominator would severely understate the common cost factor, because it would fail to capture cost of money and income tax requirements associated with assets attributable to marketing and services, common operations, and network operations general supervision. See B. Smith MO Aff. ¶ 108.

Finally, Missouri's common cost factor of 16.47 percent is on the low end of states within SBC's region. See id. ¶¶ 105-106. The Missouri PSC did not err in accepting SWBT's common cost factor.

Power, Engineering and the "ACES" Model. In order to convert the incremental investment derived from other network investment cost models into a monthly cost, SWBT uses the ACES cost model. The model does not include any embedded costs. See B. Smith MO Aff. ¶ 111. In order to provide credible evidence for predicting future costs for efficient technologies currently in use, SWBT begins with data from these currently efficient technologies. Id.

Current costs are used, therefore, only as a basis for estimating future costs. As Barbara Smith explains, SWBT developed factors by dividing current expenses by current investments for the most efficient technologies in the current network. It then applied these factors to total forward-looking investment to calculate forward-looking costs. Id. ¶ 112. Where the model made certain embedded-cost assumptions – such as assuming, when calculating the replacement cost of buildings, that SWBT would build exactly the same number and size of buildings in the same locations – the Missouri PSC Staff recommended modifications to the way the factor was

calculated to avoid overstating certain investments. See Costing and Pricing Report at 79-80. Nothing in this record remotely supports the argument that the Missouri PSC failed to apply TELRIC principles in evaluating SWBT's ACES model.

5. Loop Rates

In the initial Missouri 271 application, some commenters took issue with certain factors that they believe inappropriately inflated the rates for unbundled loops. But the Missouri PSC applied a fill factor for distribution that was entirely appropriate, properly took into account the presence of integrated digital loop carriers, appropriately assumed the tapering of feeder cable, and correctly allocated dark fiber.

Distribution Fill. In the Kansas/Oklahoma Order, this Commission recognized the importance of setting an appropriate fill factor – "[i]f a fill factor is set too high, the particular element will have insufficient capacity to accommodate anticipated increases in demand or services outages. If a fill factor is set too low, the network could have considerable excess capacity, which results in increases to the per-unit cost higher than an efficient firm's cost." Kansas/Oklahoma Order ¶ 78. The Commission concluded that a distribution fill factor of 30 percent is "unreasonably low" and that a state commission errs when it uses "current fill, and refuse[s] to consider the forward-looking fill or assume that the fill factor would increase over time." Id. ¶ 80.

After carefully examining SWBT's cost studies and assumptions regarding distribution fill, the Missouri PSC rejected SWBT's proposal to use its actual fill factors as "the best representation of utilization in a rapidly changing competitive environment." Costing and Pricing Report at 13. Instead, the Missouri PSC Staff recommended increasing the distribution fill factor to 40 percent. Although the Staff rejected SWBT's current fill, there is substantial

evidence that distribution fill has remained remarkably constant over time and that it is not likely to increase significantly going forward. See B. Smith MO Aff. ¶¶ 80-81.

The 40 percent distribution fill factor is precisely the same that the Texas Public Utility Commission established and that this Commission effectively approved in granting Southwestern Bell's section 271 application in Texas. Moreover, this Commission did not reject a 40 percent fill factor in the Massachusetts Order.[30] In the absence of any argument about how the Missouri PSC erred in selecting a distribution fill of 40 percent, there is no basis for rejecting the state commission's conclusion on this issue.

Integrated Digital Loop Carrier. As Barbara Smith explains, it is simply unrealistic to assume that SWBT's network contains nothing but integrated digital loop carriers, because "[o]nly a non-integrated DLC and its associated equipment can enable individual unbundled loops to be terminated on the MDF for cross connection to the CLEC. Unbundled loops cannot be extracted or 'groomed' from an IDLC system without significant additional expense." B. Smith MO Aff. ¶ 89. SWBT's cost studies reasonably assume the presence of facilities such as the Remote Terminal, the Central Office Terminal, the plug-in universal DLC circuit cards (as well as the cabinets and huts for all this equipment) that allow the unbundled loops to be terminated on a non-integrated basis. Id. ¶ 90.

In ordering SWBT to assume that 25 percent of its network would be served through integrated DLCs, the Missouri PSC lowered the loop costs without permitting SWBT to recover the additional costs for direct labor and engineering that would be required to provision an unbundled loop using an integrated configuration. Id. ¶ 91. Rather than overstating forward-

[30] Massachusetts Order ¶ 39.

looking costs for the loop, the Missouri PSC's assumption of integrated DLC probably understated such costs.

Tapering of Feeder Cable. SWBT's cost studies account for cable tapering by weighing different sizes of cable to develop an average pair foot investment for the loop study. See id. ¶ 72. All of the cable sizes and their corresponding lengths from the company inventory of cable are used in the calculation of the average pair foot investment for the total cable including feeder and distribution. Id. The feeder portion is determined through an inventory of the feeder distribution interfaces ("FDIs"); the residual is assigned to the distribution portion. Because SWBT's cost studies take the entire inventory of cable sizes as a starting point to determine the average cost per pair foot for the entire cable, any feeder cable sizes that are not included because of the assumption that each feeder segment terminates in only one FDI would then become part of the distribution cable. Although this methodology may slightly overstate the cost of the feeder cable, it slightly understates the costs of the distribution cable. Id. The cost study clearly takes into consideration the tapering of feeder cable.

Allocation of Dark Fiber. The Missouri PSC Staff significantly modified SWBT's fill factor for dark fiber in order to ensure that SWBT could not recover the costs of dark fiber in its UNE loop rates where the fiber fill factor already allowed SWBT to recover conduit investment associated with unused fiber. SWBT had proposed a fiber fill factor of 60 percent, but the Missouri PSC Staff increased the fill factor to 95 percent. Costing and Pricing Report at 78 ("This would allow SWBT to retain 5 percent of its fibers for breakage.").

With respect to conduit investment, the Missouri PSC Staff expressly rejected the suggestion that SWBT might be double recovering its dark fiber investment. Although building the fiber fill factor into the conduit factor "would raise some concerns since the unused fiber is

dark fiber and the investment associated with dark fiber can be recovered separately," id. at 18, the Missouri PSC Staff addressed such concerns: "[a] review of the dark fiber cost studies indicated that no conduit costs are being recovered through dark fiber so the issue of double recovery does not apply," id.; see also B. Smith MO Aff. ¶¶ 92-93.

6. Switching Rates

In establishing the UNE switching rates, the Missouri PSC properly took into account discounts on initial purchases of switches and appropriately permitted SWBT to apply a hardware factor for additional switch investments. The resulting switching rates are entirely consistent with this Commission's TELRIC methodology.

Switch Discounts. SWBT's Switching Cost Information System ("SCIS") model develops switch discounts using a weighted mix of switch discounts for initial placements of switching equipment and growth jobs to add new line equipment. See B. Smith MO Aff. ¶¶ 51-52. The prices and discounts were determined by examining SWBT's procurement contracts with its switch vendors, and SWBT developed a weighted average discount for each vendor by reviewing contract information. Id. ¶ 52. The Missouri PSC closely reviewed the SCIS model, making several modifications based on its belief that "SWBT is receiving discounts in addition to those used in SWBT's original cost studies." Costing and Pricing Report at 32. The Staff reviewed vendor contracts, Firm Price Quotes, and purchase orders, leading to different discounts on Nortel and Lucent switches. Id. The result of the Staff's modifications was that the discount applicable to Lucent switches more than doubled and the Nortel discount increased by 28 percent. See B. Smith MO Aff. ¶ 53.[31]

[31] The SWBT switching cost studies do not take into account discounts on engineering and installation costs for the simple reason that SWBT's contracts at the time with Nortel and Lucent did not include discounts for engineering and installation. See B. Smith MO Aff. ¶ 56.

In the New York Order, this Commission considered and rejected a virtually identical argument by AT&T to the New York Public Service Commission's treatment of switch discounts. See 15 FCC Rcd at 4083-86, ¶¶ 242-247. Bell Atlantic had proposed a cost per line of $586, compared to AT&T's proposal of $125 per line. "The New York Commission then conducted its own examination into switching costs, after which it estimated a per-line switch cost of $303, which it reduced to $192 to account for declining switch prices within the industry." Id. at 4083-84, ¶ 242. This Commission concluded, based on the evidence in the record, that "the New York Commission has already considered AT&T's allegation that Bell Atlantic's proposed switch costs were too high and responded appropriately. Bell Atlantic may only recover $192 per switch per line, a significant reduction from its original proposal of $586 per line and an amount much closer to AT&T's estimation." Id. On review, the D.C. Circuit expressly concluded that this decision was reasonable. AT&T Corp., 220 F.3d at 617.

Just as in New York, the Missouri PSC made adjustments to SWBT's original SCIS studies to account for lower switch prices. The adjustments brought the price per line down substantially. Like the New York Commission, the Missouri PSC ordered a switching rate that was far closer to AT&T's proposal than it was to SWBT's. See B. Smith MO Aff. ¶ 53.

Indeed, the record in New York revealed that while the New York Commission reduced the switching cost per line in light of "declining switch prices within the industry," New York Order, 15 FCC Rcd at 4084, ¶ 242, the New York Commission had not, in fact, incorporated any switch discounts on purchases of new switches. See AT&T Corp., 220 F.3d at 617. In marked contrast to the Missouri PSC – which expressly incorporated substantial switch discounts into its

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The Missouri PSC Staff indicated only that it "could not confirm whether or not SWBT receives discounts on engineering and installation" Costing and Pricing Report at 32.

final switching rates – the New York Commission declined to do so at all, reasoning that "'switching costs in general represent a much smaller component of CLEC expense than do the much more significant [loop] costs.'" Id. (quoting Order Denying Motion to Reopen Phase 1 and Instituting New Proceeding at 12, Case 95-C-0657 (N.Y. Pub. Serv. Comm'n Sept. 30, 1998)). Nevertheless, both this Commission and the D.C. Circuit on review concluded that the New York Commission's decision not to incorporate any switch discounts was reasonable. In light of the New York Order, it is difficult to see how a state commission such as the Missouri PSC that applies substantial switch discounts could be acting unreasonably.

Moreover, this Commission expressly concluded that it was "not persuaded by AT&T's assertion that in our Universal Service proceeding, we disallowed the cost recovery of 'augmented switches,' and that Bell Atlantic's recovery includes such cost recovery, which violates our rules." New York Order, 15 FCC Rcd at 4085, ¶ 245. The Commission reiterated its position that the federal Universal Service cost model was developed for purposes of determining federal universal service support and that it may not be appropriate to use nationwide values for other purposes, "'such as determining prices for unbundled network elements.'" Id. (quoting Tenth Report and Order, Federal-State Joint Board on Universal Service, 14 FCC Rcd 20156, 20172, ¶ 32 (1999)).

Feature Related Hardware. SWBT's local switching cost study identifies the TELRIC costs per minute of use for local switching. The study uses such inputs as switching investment, hardware investment, and minutes of use in order to convert investments into costs using the ACES model. Feature related hardware consists of hardware components needed to provide features that are not part of the office reports used by the SCIS model to develop the total investment for local switching. The Missouri PSC Staff carefully reviewed SWBT's feature

related hardware factor and made several significant adjustments to it. For example, it required SWBT to apply the factor only to DMS-100 and 5ESS switches, because the hardware data used to develop the factor had been gathered only from these switches; because neither DMS-10 or Ericsson AXE-10 switches had been used for data gathering, the Missouri PSC concluded that the factor could not be applied to investments in those switches. Costing and Pricing Report at 43.

The Missouri PSC Staff identified one category of equipment – "input/output port for simplified message desk interface" – as a potential issue, because the Staff did not know what types of ports are included in this category. Id. The Missouri PSC merely raised the question whether certain investments might be double counted. In fact, there is no double recovery. The maintenance input/output ports are not included in another investment category in the SCIS study, so it was entirely appropriate that they be included in the hardware investment total. See B. Smith MO Aff. ¶ 63.

7. Nonrecurring Rates

Nonrecurring charges are intended to recover the one-time labor and expensed material costs associated with provisioning unbundled network elements. In Missouri, as in each state in its region, SWBT carried out cost studies for calculating nonrecurring costs by identifying work groups involved in particular tasks; identifying the time required to perform each function and the labor rate associated with the employee performing the function; multiplying the labor rate by the labor time to determine the cost for performing the function; and grouping the work functions by cost element and totaling them to establish a forward-looking nonrecurring cost per element. See B. Smith MO Aff. ¶ 32.

After carefully reviewing these studies, the Missouri PSC Staff concluded that certain substantial downward adjustments were appropriate. See Costing and Pricing Report at 121-24. Indeed, the Missouri PSC ultimately accepted the Staff's recommendation to set the rates for nonrecurring charges at 50 percent of the cost-based rates proposed by SWBT. The M2A incorporates a UNE pricing appendix that reflects a further 25-percent reduction in nonrecurring charges (subject to the T2A floor).

Although SWBT challenged the 50-percent reduction in nonrecurring charges as unjustified and arbitrary, no other carrier ever challenged in district court the resulting rates as inconsistent with forward-looking cost principles. On the contrary, in its brief to the United States District Court for the Western District of Missouri, AT&T defended these rates: "Given the significant discrepancies between AT&T and SWBT as to the efficient amount of time required to perform NRC functions, Staff's recommendation to reduce NRCs by 50 % from SWBT's proposals, which was subsequently adopted by the PSC, far from being arbitrary and capricious, constitutes a reasonable policy determination supported by the administrative record." AT&T's Opposition to SWBT's Motion for Summary Judgment at 25, AT&T Communications of the Southwest, Inc. v. Southwestern Bell Tel. Co., No. 97-1573-CV-W-5 (W.D. Mo. filed Nov. 16, 1998) (emphasis added).[32] Moreover, on appeal to the Eighth Circuit, AT&T reiterated its defense of the nonrecurring charges: "far from adopting a random compromise, the PSC reasonably adopted the Staff's conclusions, which were based on a conscientious effort to determine accurate NRCs on the basis of the best evidence available in the record." Brief for Defendant-Appellee AT&T Communications of the Southwest, Inc. at 50, Southwestern Bell Tel. Co. v. Missouri Pub. Serv. Comm'n, Nos. 99-3833 & 99-3908 (8th Cir.

[32] See Hughes MO Aff. Attach. A.

filed Feb. 14, 2000) (emphasis added); see also id. at 51 ("The PSC properly . . . reduced [SWBT's proposals] to more appropriate levels according to the best evidence available in the record.").[33]

Barbara Smith explains in her Affidavit that differences in the nonrecurring charges among Texas, Kansas, and Missouri are attributable to differences in the way each state commission estimated forward-looking costs associated with time and labor rates. See B. Smith MO Aff. ¶¶ 139-141. In predicting how much such costs would decline over time, it is hardly surprising that each state commission made different assumptions and arrived at different final rates. Id. ¶ 141. In Kansas and Texas, the state commissions ordered specific reductions in the labor rates, while making other downward adjustments that they never explained. Id. ¶ 140. In Missouri, when faced with uncertainty and incomplete data, the Missouri PSC did the best it could. That it ultimately arrived at higher nonrecurring charges for some elements (as well as lower charges for others) is to be expected.

8. Interim Rates

As explained above, the M2A offers, on an interim basis subject to true-up, all of the prices for UNEs and services that were ordered by the Missouri PSC in the Second Arbitration Order as part of Case No. TO-98-115. This Commission has made clear that "the mere presence of interim rates will not generally threaten a section 271 application so long as an interim solution to a particular rate dispute is reasonable under the circumstances, the state commission has demonstrated its commitment to our pricing rules, and provision is made for refunds or true-ups once permanent rates are set." Texas Order, 15 FCC Rcd at 18394, ¶ 88. A great number of these interim rates have been set at zero. In fact, 102 out of the 136 interim rates from Case No.

[33] See id. Attach. B.

TO-98-115 are set at zero even though the Missouri PSC recognized that SWBT incurred real costs. See Hughes MO Aff. ¶¶ 43, 48.

Clearly, the CLECs have benefited from the fact that these interim rates have been in place so long. In fact, when SWBT proposed an expedited procedural schedule in the docket to replace these interim rates with permanent rates, the CLECs opposed it. Instead, they convinced the Missouri PSC to adopt a schedule that would postpone any hearing until the end of this calendar year. See id. ¶ 50; see also App. H – MO, Tabs 2, 4, 6 & 12. The CLECs are clearly not in any hurry to replace these interim rates, for SWBT will bear the financial risk from providing zero-based interim rates beyond the six-month true-up period. See Hughes MO Aff. ¶ 50.

9. UNE Rates Are Not To Blame for CLECs' Lack of Commitment to Facilities-Based Competition

This Commission has expressly rejected the argument that the lack of substantial local competition in a state constitutes evidence that the UNE rates are not TELRIC-based: "[W]e do not accept [the] assertion that competitors lack a sufficient profit margin between [the BOC's] retail and wholesale rates to allow local residential competition over the UNE-P, which indicates that the UNE rates are not TELRIC-based." Massachusetts Order ¶ 41. As the Commission went on to explain, "efficient entry" simply means that "competitors seeking entry will face the same sorts of costs they would face in a fully competitive market, that is, TELRIC-based UNE rates. . . . Contrary to AT&T's assertion, the concept of 'efficient entry' does not guarantee that any competitors will necessarily enter the market. Even if competitors can gain 'efficient entry' to a market through the availability of TELRIC-based UNE rates, they may still decide not to enter based on their independent determinations that they cannot turn a sufficient profit in the market." Id. ¶ 42.

The former Chairman of this Commission and the former Chairman of the Texas Commission testified in May before Congress that the principal reason for the lack of residential competition is not that wholesale rates are too high but rather that retail rates are too low. According to former Chairman Reed Hundt, "[i]n terms of residential, voice, telephone service . . . about 40 percent of all consumers are paying less than the cost to provide a service. . . . And there's no way that someone else is building an overlapping network to repeat the experience of offering a below-cost service."[34] And Texas Commission Chairman Pat Wood agreed:

> Residential rates are low. . . . They may even be lower than cost. . . . It will be difficult for competitors to ever come into the Texas market – just as it would be difficult to get into the California electricity market – if you can't sell for the proper price or compete with the proper price what you just bought for $10 more. . . . [I]t's important to know that residential rates were purposely subsidized for 80 years. And business rates and long-distance rates are kept high to make up for that.[35]

According to the Texas Commission Report,[36] "cross-subsidies that have traditionally kept residential rates artificially low now contribute to the lack of competition for residential customers. The same cross-subsidies have provided cream-skimming opportunities in large metro and business markets." Texas Commission Report at x. Rather than blaming SWBT, the Texas Commission recognized that the primary reason that competition looks less viable for certain rural and residential customers, as compared to business and urban markets, is "rooted in

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[34] Reed Hundt, Former Chairman, FCC, The Telecom Act Five Years Later. Is it Promoting Competition?, Panel Discussion to Hearing of the Senate Antitrust, Business Rights and Competition Subcommittee of the Judiciary Committee (May 2, 2001) (emphasis added).

[35] Pat Wood, Chairman, Texas Public Utilities Commission, The Telecom Act Five Years Later. Is it Promoting Competition?, Panel Discussion to Hearing of the Senate Antitrust, Business Rights and Competition Subcommittee of the Judiciary Committee (May 2, 2001).

[36] Public Utility Commission of Texas, Scope of Competition in Telecommunications Markets of Texas (Jan. 2001).

underlying market conditions and in the historical regulatory pricing system for local telephone service." Id. at 85. The continuation of Texas' long-standing public policy to provide universal service and to maintain low rates for basic residential local service "means that some segments of the market may not receive rates that reflect the true cost of the service. . . . Most residential and rural customers receive basic local services at rates well below their true cost (with the remainder of the cost subsidized by Texas and federal universal service payments and over-priced vertical or nonbasic services)." Id. at xi.

Nevertheless, the Texas Commission Report also recognizes that local competition is thriving in certain markets: "The Large Metropolitan areas and the Suburban counties, which combined comprise almost 60 percent of Texas' population, have heavy concentrations of CLECs. Data show that the Dallas and Houston metro areas have about twenty or more CLECs serving customers, while San Antonio and Austin have ten or more CLECs serving customers. Many rural areas that allow for customer choice have a choice of two, three, or more CLECs, in addition to an ILEC." Id. at 78. And the market for "business customers in the Large Metro areas of Texas appears to be competitive. Facilities-based competition has provided increased capacity for CLECs to compete with ILECs over the long term." Id. at 83.

10. A Further Voluntary Reduction in UNE Rates

For all of the reasons discussed above, it is clear that the recurring and nonrecurring UNE rates contained in the M2A were established in accordance with the TELRIC methodology. The Missouri PSC has demonstrated its commitment to this Commission's costing principles, and no CLEC has ever challenged the rates established by the Missouri PSC in federal district court.

Nevertheless, as a compromise to allay the concerns of some CLECs and others that the Missouri rates are too high, Southwestern Bell has voluntarily lowered some of the TELRIC-

based recurring and nonrecurring rates currently available in the M2A. These reductions are specifically targeted to stimulate further competition in the provision of local telecommunications services in Missouri. In particular, SWBT has voluntarily agreed to reduce the rates in the M2A as follows:

- Recurring rates for certain loops are reduced by an overall average of ten percent.
- Recurring rates for certain signaling, switching, and transport rate elements are reduced by an overall average of 18.5 percent, provided that the reduction does not take the rate in question below the rate offered by SWBT in Texas.
- The nonrecurring rate for an analog line port is reduced by 95 percent.

See Hughes MO Aff. ¶ 56 & Attach. C (revised Appendix Pricing UNE – Schedule of Prices). These voluntary price reductions have been filed with the Missouri PSC for approval, and will be available to Missouri CLECs in the M2A and pursuant to amendment to existing interconnection agreements. See id. ¶ 56 & Attach. C.

III. SBC AND ITS AFFILIATES OFFER FOR RESALE AT A WHOLESALE DISCOUNT THOSE ADVANCED TELECOMMUNICATIONS SERVICES THAT THEY OFFER AT RETAIL

The 1996 Act requires an incumbent LEC "to offer for resale at wholesale rates any telecommunications service that the carrier provides at retail to subscribers who are not telecommunications carriers." 47 U.S.C. § 251(c)(4)(A). As this Commission has interpreted the statute, "[t]he category of services subject to the provisions of section 251(c)(4) is determined . . . by whether those services are telecommunications services that an incumbent LEC provides (1) at retail and (2) to subscribers who are not telecommunications carriers."[37]

[37] Second Report and Order, Deployment of Wireline Services Offering Advanced Telecommunications Capability, 14 FCC Rcd 19237, 19242, ¶ 9 (1999) ("Second Advanced Services Order"), aff'd, Assocation of Communications Enters. v. FCC, 253 F.3d 29 (D.C. Cir. 2001) ("ASCENT II").

Advanced services, such as xDSL transmission and packet switching, are "telecommunications services" under the Act to the extent that they do "no more than transport information of the user's choosing between or among user-specified points, without change in the form or content of the information as sent and received."[38]

In Association of Communications Enterprises v. FCC, 235 F.3d 662 (D.C. Cir. 2001) ("ASCENT I"), the court of appeals held that an incumbent LEC's decision to offer telecommunications services through a wholly owned affiliate does not eliminate the obligation to comply with the requirements of section 251(c).[39] Prior to ASCENT I, the fact that SBC was providing advanced services through its wholly owned data affiliate, Advanced Solutions, Inc. ("ASI"), rather than through SWBT meant that the obligations of section 251(c) simply did not apply. Indeed, this was the view of the Commission in approving the SBC/Ameritech merger: "We believe that the affiliate structure set forth in the conditions will ensure that an SBC/Ameritech advanced services affiliate occupies a position in the market comparable not to an incumbent, but rather to . . . non-incumbent advanced services competitors."[40]

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[38] First Report and Order, Deployment of Wireline Services Offering Advanced Telecommunications Capability, 13 FCC Rcd 24011, 24030, ¶ 35 (1998) ("First Advanced Services Order") (citing 47 U.S.C. § 153(46)).

[39] Under the terms of the ASCENT I decision, the affiliate's new obligations are not limited to resale under section 251(c)(4). Therefore, to the extent appropriate and applicable, SBC's advanced-services affiliate also provides for interconnection, unbundled network elements, and collocation pursuant to the requirements of section 251(c). See generally Habeeb Aff. ¶¶ 46-61; ASI-Logix Agreement – AR, §§ 15-32 (App. E - AR, Tab 25); ASI-Logix Agreement – MO, §§ 15-32 (App. G - MO, Tab 114).

[40] Memorandum Opinion and Order, Applications of Ameritech Corp. and SBC Communications, Inc. For Consent To Transfer Control, 14 FCC Rcd 14712, 14902, ¶ 461 (1999) ("SBC/Ameritech Merger Order"), vacated in part, ASCENT I, 235 F.3d 662 (D.C. Cir. 2001).

In order to comply with the requirements of ASCENT I, SBC extended the requirements of section 251(c) to ASI. As John Habeeb describes in his affidavit, ASI has now entered into agreements in both Missouri and Arkansas to allow CLECs to resell the advanced services it provides at retail by offering such services at the wholesale discount applicable to Southwestern Bell's own retail services in both states. See Habeeb Aff.; ASI-Logix Agreement – MO; ASI-Logix Agreement – AR. As a result of ASCENT I, therefore, the obligations of section 251(c) apply to the services provided by ASI in the same way that they would apply were those services provided by SWBT.

SBC provides three categories of DSL-related services: (1) Retail Telecommunications Services: Through ASI, SBC sells to business customers and to certain grandfathered residential customers certain advanced services at retail, and these services are now being offered to CLECs for resale at the appropriate wholesale discount in Missouri and Arkansas; (2) Wholesale Telecommunications Services: Also through ASI, SBC sells at wholesale DSL transport services to unaffiliated ISPs that in turn offer retail information services – high-speed DSL Internet access services; and (3) Retail Information Services: In SWBT in-region states, SBC sells, through its affiliate Southwestern Bell Internet Services, Inc. ("SBIS"), high-speed DSL Internet access services at retail to end-user subscribers. Of these three categories of DSL-based services, only the first – Retail Telecommunications Services – is governed by the resale provisions of section 251(c)(4).

A. SBC Offers for Resale at the Wholesale Discount All Grandfathered Telecommunications Services and Customer Service Arrangements That It Offers at Retail

In Missouri and Arkansas today, SBC offers two forms of DSL-related retail telecommunications services – grandfathered residential DSL transport services and customer

service arrangements ("CSAs") with business end users. As this Commission made clear in the Second Advanced Services Order, "advanced services sold at retail by incumbent LECs to residential and business end-users are subject to the section 251(c)(4) discounted resale obligation, without regard to their classification as telephone exchange service or exchange access service." 14 FCC Rcd at 19238, ¶ 3. In other words, because these grandfathered residential services and CSA business services are telecommunications services offered at retail, and because ASCENT I requires retail telecommunications services offered by a separate data affiliate to be resold as if these services were being provided by the incumbent LEC, these services are subject to the resale requirement of section 251(c)(4).

1. Grandfathered Retail Services

Prior to the merger of Ameritech and SBC in the fall of 1999, SWBT sold a DSL transport service directly to residential customers at retail. This DSL transport service was sold by the telephone company to residential subscribers separate and apart from any Internet access service, and the customer had to arrange to receive such Internet access service directly from an ISP. SWBT billed the end-user customer for the DSL transport service alone. See Habeeb Aff. ¶ 32.

As a condition for approving the SBC-Ameritech merger, the Commission required the combined company to offer advanced services through a separate affiliate, which SBC called Advanced Solutions, Inc. ("ASI"). The customers who had received DSL transport services directly from the telephone company prior to the merger were transferred to ASI in accordance with the merger conditions. Soon after the merger was completed, ASI decided to discontinue selling the DSL transport service to residential customers. It had reached the business decision no longer to provide a retail DSL transport service directly to end users but to focus, instead, on

the wholesale provision of DSL transport to ISPs. ASI has accordingly ceased making this DSL transport service generally available on a mass-market basis to end-user customers at retail. ASI agreed, however, to grandfather existing customers. See id.

At this time, ASI has fewer than 1,100 grandfathered retail residential customers in Missouri and fewer than 200 such customers in Arkansas. See id. As the Commission indicated in the Local Competition Order, "when an incumbent LEC grandfathers its own customers of a withdrawn service, such grandfathering should also extend to reseller end users. For the duration of any grandfathering period, all grandfathered customers should have the right to purchase such grandfathered services either directly from the incumbent LEC or indirectly through a reseller." 11 FCC Rcd at 15977-78, ¶ 968. Consistent with 47 C.F.R. § 51.615, CLECs may resell, at wholesale rates, these DSL transport services for resale to these same grandfathered customers to whom ASI provides such services. See Habeeb Aff. ¶ 43; ASI-Logix Agreement – AR, § 11(D); ASI-Logix Agreement – MO, § 11(D). As John Habeeb discusses in his affidavit, ASI will offer electronic and manual pre-ordering and ordering for resale of these services. See Habeeb Aff. ¶¶ 56-57.

Because ASI's business plan simply does not include retail DSL transport services, ASI has been moving these grandfathered retail transport customers to ISPs, with those customers' consent. See id. ¶ 33. The number of grandfathered retail residential customers should therefore decrease over time. But for as long as these retail customers exist, SBC will make the DSL transport services available at a wholesale discount to any CLEC that wishes to serve such customers.[41]

[41] A critical distinction between ASI, on the one hand, and Verizon Advanced Data, Inc. ("VADI"), on the other hand, is that ASI came to the business decision some time ago that it would no longer offer a DSL telecommunications service to end-user subscribers at retail.

2. Customer Service Arrangements

SBC, through ASI, offers a number of retail telecommunications services to business customers in the form of CSAs. The services provided through these CSAs include Frame Relay, ATM Cell Relay, Native LAN Plus, and DSL transport of business customers' remote local area networks. See Habeeb Aff. ¶ 16. SBC offers these CSAs to any "similarly situated" customer that meets the terms and conditions of that particular arrangement.[42] See, e.g., ASI-Logix Agreement – MO, § 11(G); ASI-Logix Agreement – AR, § 11(G). If a customer elects to terminate its service with SBC, it may be subject to termination liabilities to which the customer has agreed and that are contained in the CSA.[43] Although CSAs are limited to specific locations, a similarly situated customer can request a CSA that would be available for resale. See ASI-Logix Agreement – MO, § 11(G); ASI-Logix Agreement – AR, § 11(G). These are the same requirements that apply to the resale of any CSAs in Arkansas or Missouri. For CSAs, SBC will provide manual OSS similar to the manual OSS provided by SWBT for large customer CSAs.

VADI, however, currently provides DSL telecommunications services to end user subscribers through a retail tariff. Because VADI continues to offer DSL transport services "on a retail basis, these services are eligible for a wholesale discount under section 251(c)(4)," Connecticut Order ¶ 30, and the Commission expected Verizon to "develop[ ] permanent order processing procedures," id. ¶ 42. There is no similar need for ASI to develop such procedures, because, with the exception of a dwindling number of grandfathered customers, ASI simply does not offer DSL telecommunications services at retail to end-user subscribers.

[42] Second Louisiana Order, 13 FCC Rcd at 20781-82, ¶ 316 (1998) ("limiting the resale of CSAs to similarly situated customers, on a general basis, may be a reasonable and non-discriminatory resale restriction because it is sufficiently narrowly tailored. CSA offerings, by their nature, are priced to a specific set of customer needs, sometimes based on a competitive bidding process. To this extent, it is reasonable to assume that BellSouth's ability to offer a particular CSA at a given price will be dependent on certain end user characteristics"). ASI also offers frame relay services to business customers. See Habeeb Aff. ¶ 16. These services are likewise offered to CLECs pursuant to section 251(c)(4). See id. ¶ 41.

[43] See New York Order, 15 FCC Rcd at 4147, ¶ 390.